Moody's Investors Service

Global Credit Research
Rating Update
21 MAY 2004

Rating Update: **California (State of)**

MOODY'S UPGRADES CALIFORNIA TO A3, BASED ON TREND OF RECOVERY IN STATE ECONOMY AND IMPROVED FINANCIAL OUTLOOK. RATING OUTLOOK REMAINS POSITIVE.

State
CA

Opinion

NEW YORK, May 21, 2004 -- Moody's Investors Service has upgraded the State of California's general obligation bonds to A3, from Baa1, and assigned a positive rating outlook. The upgrade reflects a now established trend of recovery in the state's economy and tax revenues, as well as an improved state budgetary and liquidity outlook. California's rating still remains well below the 50-state average of Aa2, due to its ongoing fiscal challenges. However, continuation of current trends is expected, and reflected in the positive rating outlook.

Approximately $35 billion of outstanding G.O. bonds and nearly $9 billion of General Fund-supported lease revenue bonds and General Fund-enhanced tobacco bonds are affected. The current rating action takes into account the large increase in long-term state debt that has occurred recently, which results in an above-average level of indebtedness relative to other states.

PRIVATE SECTOR EMPLOYMENT AND INCOME RESUME MODERATE GROWTH.

Private sector employment in the state has resumed a moderate pace of growth, recording an average monthly increase of about 100,000 jobs in the first four months of the year (including a 130,000 increase in April) compared to the year-earlier period. This roughly 1% rate of increase is a significant improvement from the average monthy gain of about 20,000 private sector jobs in the fourth quarter of last year.

The statewide employment figures mask still-weak conditions in the San Francisco Bay Area, which has not yet seen an employment turnaround. However, recent positve statistics regarding state exports of computer and electronic products may signal some underlying strengthening in the Bay Area as well.

State personal income has also resumed a moderate pace of growth, and is exceeding the nation as a whole. In the first three quarters of 2003, the state recorded income growth of 3.5%, compared to 3.3% for the nation. In the fourth quarter, California income growth accelerated to 4.8%, ahead of the national pace of 4.3%. For 2004, the state has revised its income growth forecast to 5.4%.

The economic recovery is evident in state tax collections for fiscal 2004. Based on actual receipts through April, the state has revised its personal income tax (PIT) forecast and now expects growth for the year of 10%. This reflects both strong wage witholding and rapid growth of stock market-related income, expected to be up more than 20% to $6.4 billion (still only about a third of its 2001 peak level). Statewide sales tax receipts are expected to be up 5.2% for the year. Looking ahead to fiscal 2005, the state is projecting PIT growth of 7%, and sales tax growth of 4.2%, both of which could prove to be somewhat conservative forecasts if current economic trends continue.

LIQUIDITY POSITION IMPROVES

The sale of the voter-approved Economic Recovery Bonds (ERB's) and the associated repayment of maturing short-term debt represents an importan milestone for California, removing its exposure to market access risk for $14 billion in short-term notes. The state has issued $8 billion of ERB's and is expected to issue an additional $3.3 billion within the next month. Depending on tax revenue and financial performance, the ERB's will be retired over the next 11 to 19 years.

The state has revised its cash flow projections for 2004 and 2005 to reflect the planned issuance of $11.3 billion of the $15 billion voter-aproved ERBs as well as the current 2005 budget proposal. The cash flows indicate that the General Fund is expected to eliminate the large deficit balances seen in the two previous years. Available cash outside of the General Fund is expected to be $6.6 bilion at 6/30/05 – plus $2 billion of recovery bond proceeds earmarked for 2005 expenditure – falling somewhat to $4.6 billion at 6/30/05. The 2005 balances would be supplemented, according to the current plan, by as much as $3.7 billion of unused recovery bond capacity. Given this position, and current economic and tax receipt trends, it appears unlikely that any significant liquidity strain will reemerge during 2005.

The General Fund's projected intra-year cash needs are also significantly reduced from earlier years, with the 2005 seasonal cash flow RAN borrowing now projected at $5 billion, a sale likely to occur in September. Although preliminary, this figure compares favorably to the state's peak short-term borrowings of $14 billion in 2004 and $12.5 billion in 2003. Depending on the form of the budget as finally enacted, the fiscal 2005 RANs could be reasonably well-secured, given the unused ERB capacity. The quality of the RANs will depend heavily on the budget risks remaining in the final enacted budget. We note that the voter authorization places no time limitation on the issuance of recovery bonds, although the Department of Finance is required to certify that proceeds will be used to fund obligations deferred from prior years.

FISCAL 2005 BUDGET PROPOSAL INCREASES SPENDING BY ALMOST 6%

The Governor's revised budget proposal for fiscal 2005 calls for General Fund expenditures (including some spending that has technically been shifted out of the General Fund) of $80 billion, representing an increase of about 5.9% from 2004. This is close to the combined rate of growth projected for PIT and sales tax revenues. The major areas of increased spending are Medicaid and other health and human services programs, where the Governor has backed away from some previously contemplated program reductions. K-14 education spending also increases significantly, although most of the increase (some $4 billion) is due to shifts in the state-local composition of funding (i.e. a proposed elimination of vehicle tax relief funding for local governments, replacing this in the state's budget with a similar amount of aid to schools).

Given the preservation of healthcare programs, and other actions taken by the administration to obtain the support of key education and local government groups affected by the budget, we view the budget plan to be more politically feasible than earlier proposals. However, even as proposed there are several areas of political and forecast risk, including expected savings from the renegotiation of certan labor contracts, the proposed state sharing in punitive damage awards, and the proposed issuance of pension bonds together with a package of pension benefit reforms. In the aggregate, we view these risks as moderate.

In addition, the budget relies on $5 billion of bonds and other non-recurring sources, plus a $1.3 billion diversion of local government revenue that is proposed to recur in 2006 but not thereafter. Based on the planned funding of some 8% of 2005 operating expenditures with these sources, the independent Legislative Analyst's Office has projected that a structural budget gap ranging between $6 billion and $8 billion will persist over the next several years. The LAO estimates include the effects of the administration's plans to restore funding to higher education and other programs in future years, while also cautioning the legislature not to endorse these plans.

The budget's structural imbalance situation represents a significant ongoing fiscal challenge for California, and is a primary reason for the still quite low bond rating relative to other states.

LONG-TERM DEBT BURDEN RISES, BUT IS STILL MANAGEABLE

Including $11.3 billion of economic recovery bonds, the state's net tax-supported debt has doubled since the end of fiscal 2001, and is now $53 billion. However, at 4.5% of aggregate personal income (ranking tenth highest among the states), the debt burden is not currently a credit concern. Scheduled annual General Fund debt service as a percent of General Fund revenue remains just under 5%. Adding the anticipated debt service on $11.3 billon of recovery bonds, and the associated pledged sales tax revenue, brings the debt service ratio to about 6%.

Given current G.O. issuance plans, including a recent large voter authorization for school construction purposes, the state's debt ratios could continue to increase somewhat in the coming years. The balance of the recovery bond authorization is also likley to be utilized.

Outlook

The rating outlook for California is positive, reflecting the current trend of state economic recovery. The pace of additional improvement in the rating could lag, or exceed, economic trends, depending on state actions regarding the budget and the associated outloook for regaining structural budget balance. However, given the current economic trend and the expected availability of unused ERB capacity, we believe there is low likelihood of any serious new liquidity strain occurring for at least the next eighteen months to two years.

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